Adequacy of State Revenues

Update of

February 8, 2002

Presentation by

Office of Financial Management

To Legislative Tax Structure Study Committee

Questions Posed by the Committee on Adequacy of State Revenues

- Do tax revenues keep up with, fall short of, or exceed change in personal income?
- Do tax revenues keep up with, fall short of, or exceed the same level of services given changes in caseload levels (including school enrollment), infrastructure needs, and governmental administration needs?
- How do changes in demand for services compare to changes in personal income?
- Do tax revenues provide adequate funding for infrastructure needs such as transportation?

Basic Question

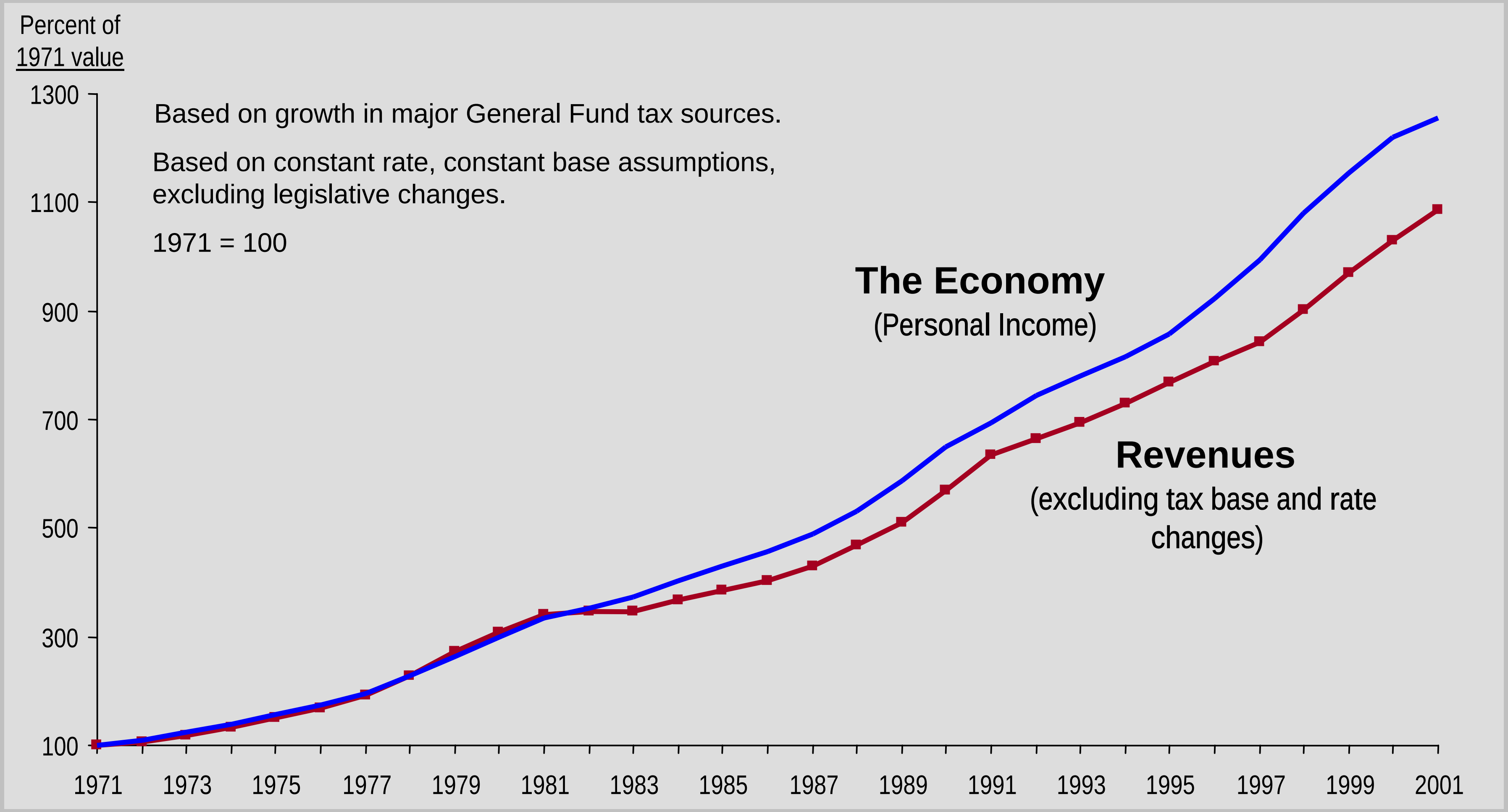
Over the long run, is the state's tax structure and revenue stream adequate to meet demands?

Outline of Discussion

- Overview of Revenue, Spending, and Personal Income Growth Trends
- Spending Pressures, Demographics, and Inflation
- Medium-Term Outlook: Spending and Revenue
    - Context
    - Assumptions
- Implications for the Longer Term

Overview of Revenue, Spending, and Personal Income Growth

Excluding tax base and rate changes, over the past 30 years General Fund revenues have grown more slowly than the economy (personal income).



Revenue elasticity is declining slowly and is expected to fall to between 0.85 and 0.90 over the next decade.

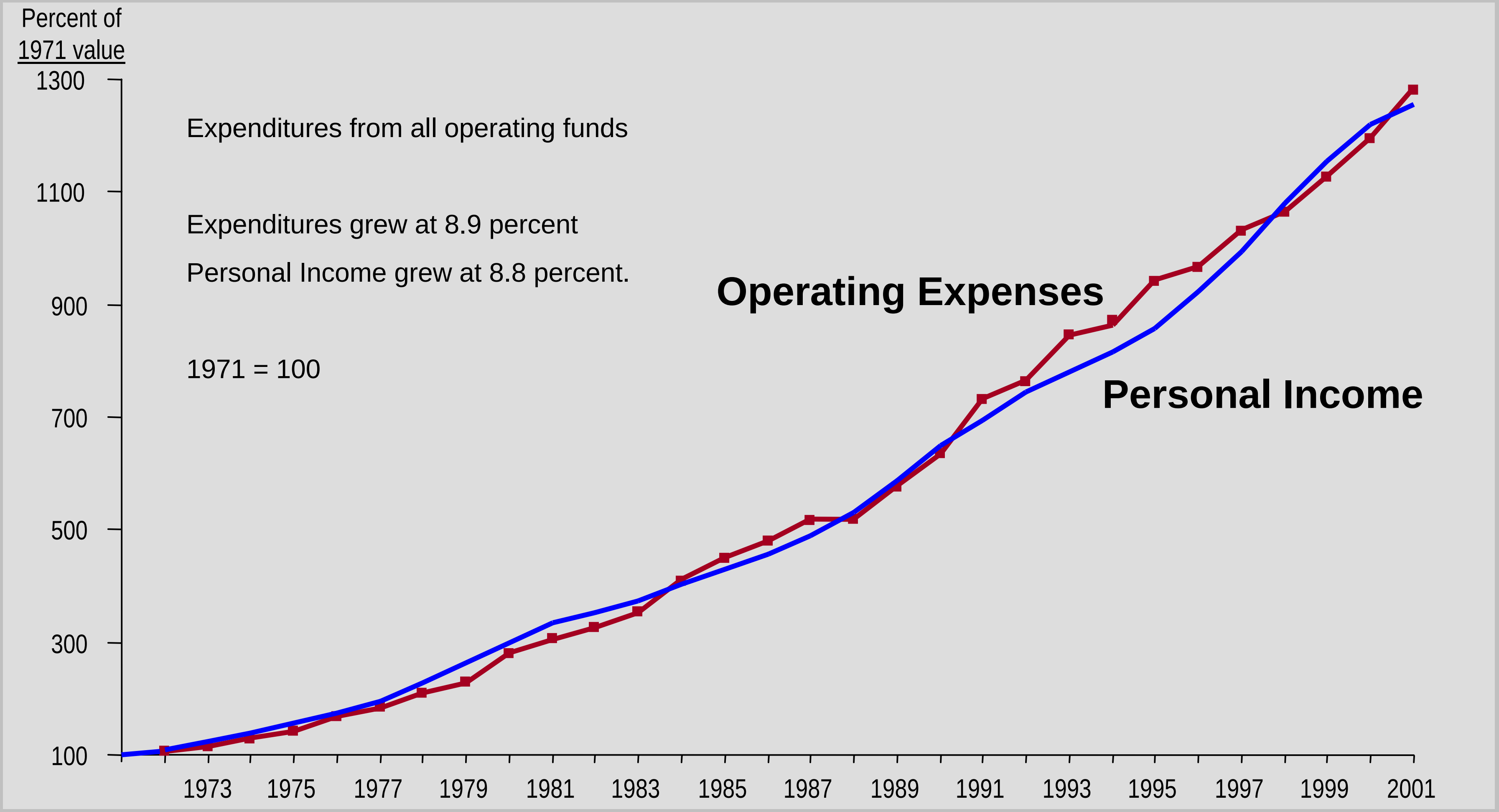
	Average Annual Personal Income Growth	Average Annual Revenue Growth*	Elasticity
Past 30 years	8.8%	8.3%	0.94
Past 20 years	6.9%	6.0%	0.87
Past 10 years	6.1%	5.5%	0.91
Forecast	5.9%	5.0%	0.85

*Excluding tax base and rate changes.

Why is elasticity expected to decline?

- **Referendum 47 and Initiative 747 slowed down General Fund property tax growth.**
- **Referendum 49 eliminated General Fund Motor Vehicle Excise Tax (MVET) – a relatively fast-growing revenue.**
- **Consumers continue to spend higher proportions of income on services rather than taxable retail items.**
- **Internet sales could further slow state sales tax collections.**

Over the past 30 years, operating expenditures from all funds have grown at about the same pace as personal income.



Summary

- Over the past 30 years, actual expenditures have grown at about the same rate as the economy (as indicated by personal income).

- Since revenues (without tax changes) tend to grow more slowly than personal income, taxes and fees were raised periodically to keep pace.

Spending Pressures, Demographics, and Inflation

Basic Tools and Concepts

Budget Drivers

Specific Population Growth + Specific Inflation ± Utilization Rates ± Policy Change

Personal Income

General Population Growth + General Inflation ± Real per Capita Personal Income Growth (Productivity Gains)

I-601 Fiscal Growth Factor

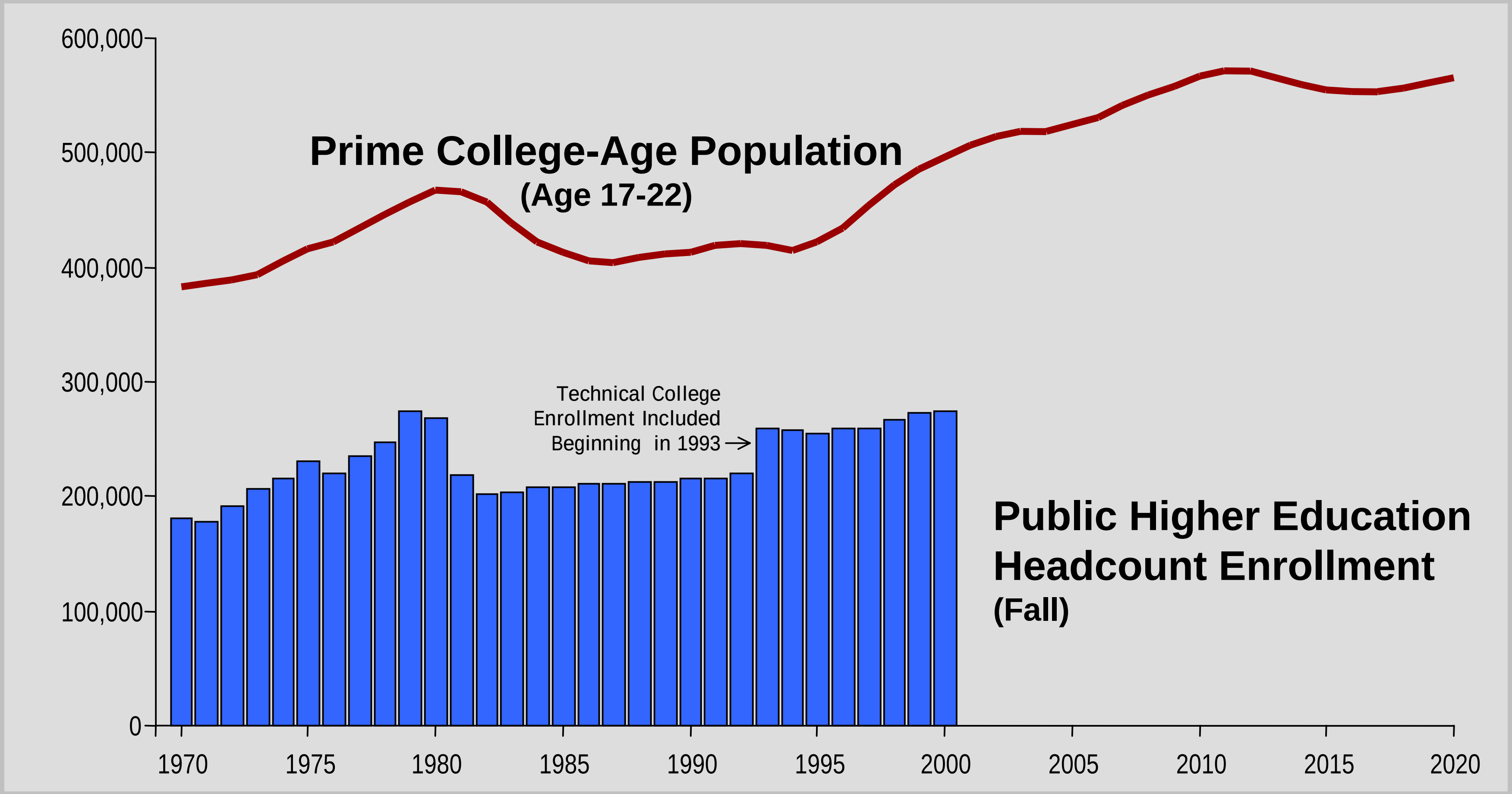
Revenue

About 85-90% of Personal Income

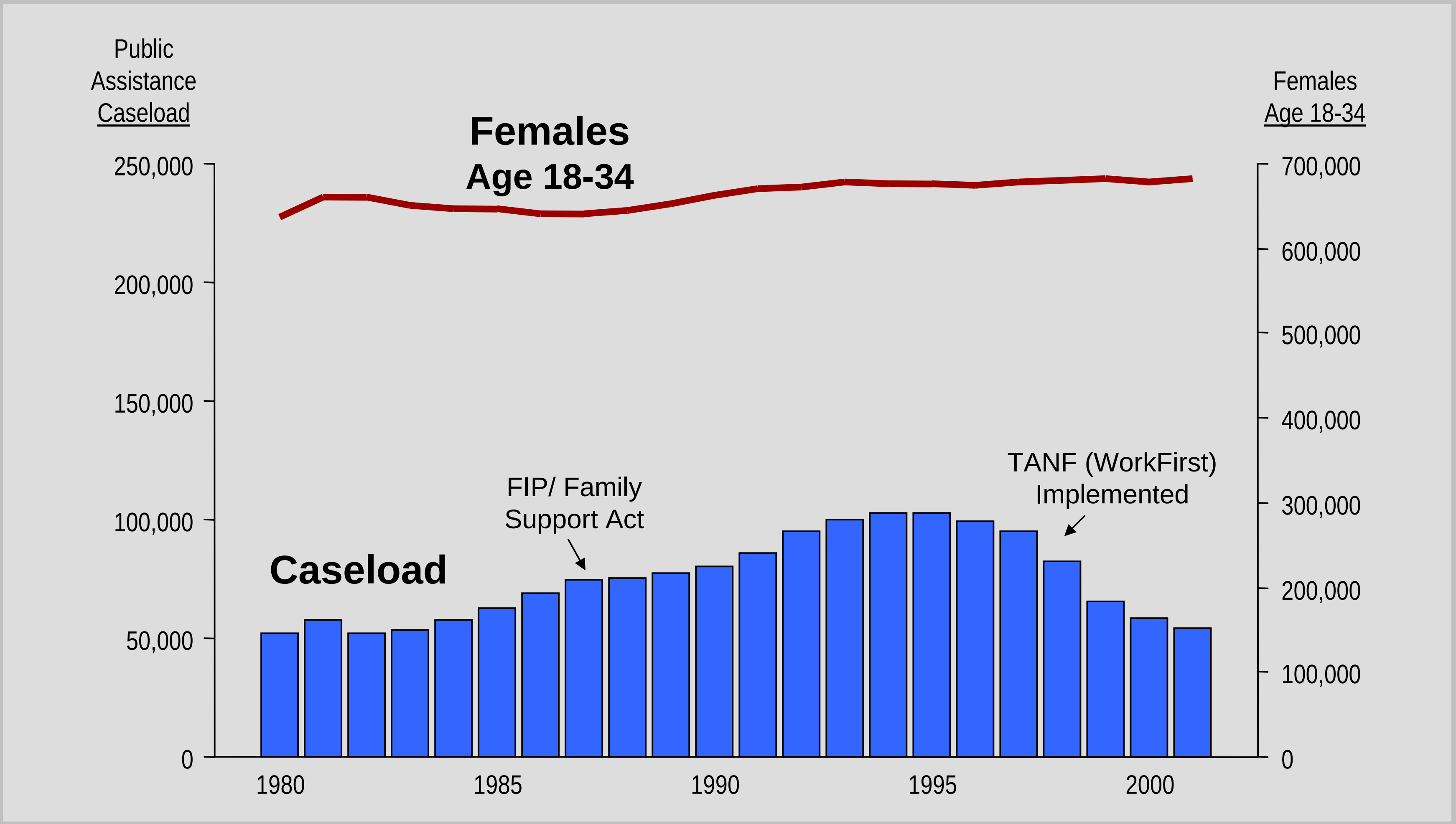
Budget pressures and personal income growth diverge…

- when specific population budget drivers, like the age 5-17 school population, grow much faster or slower than general population growth
- when specific inflation budget drivers, like "health care inflation," grow much faster or slower than general inflation
- when utilization rates for government services change – e.g., change in the percent of women in child-bearing years on public assistance rolls
- when policy changes increase or reduce government services

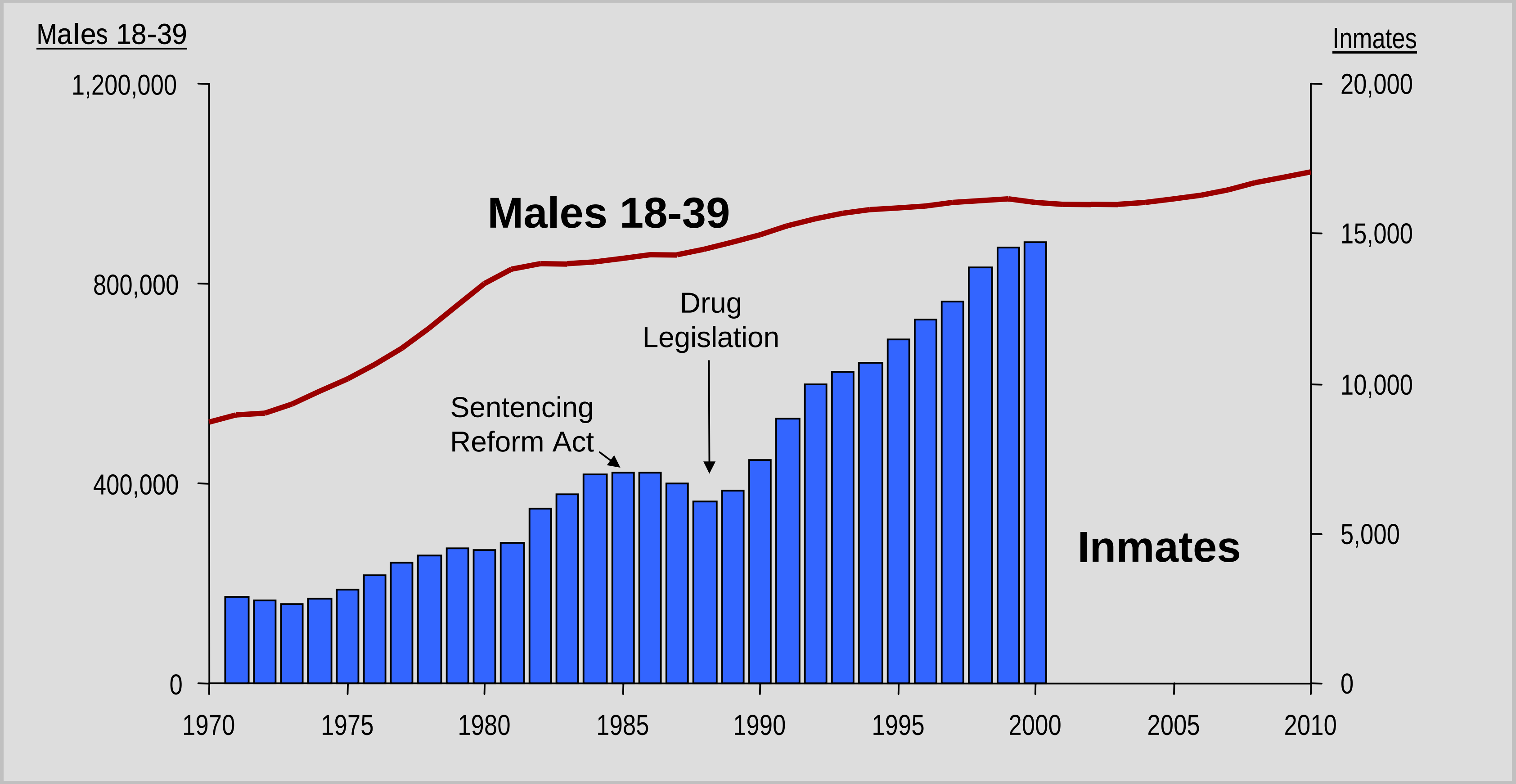
Enrollments in higher education have tracked well with demographics. Demographic pressures in higher education are now strong.



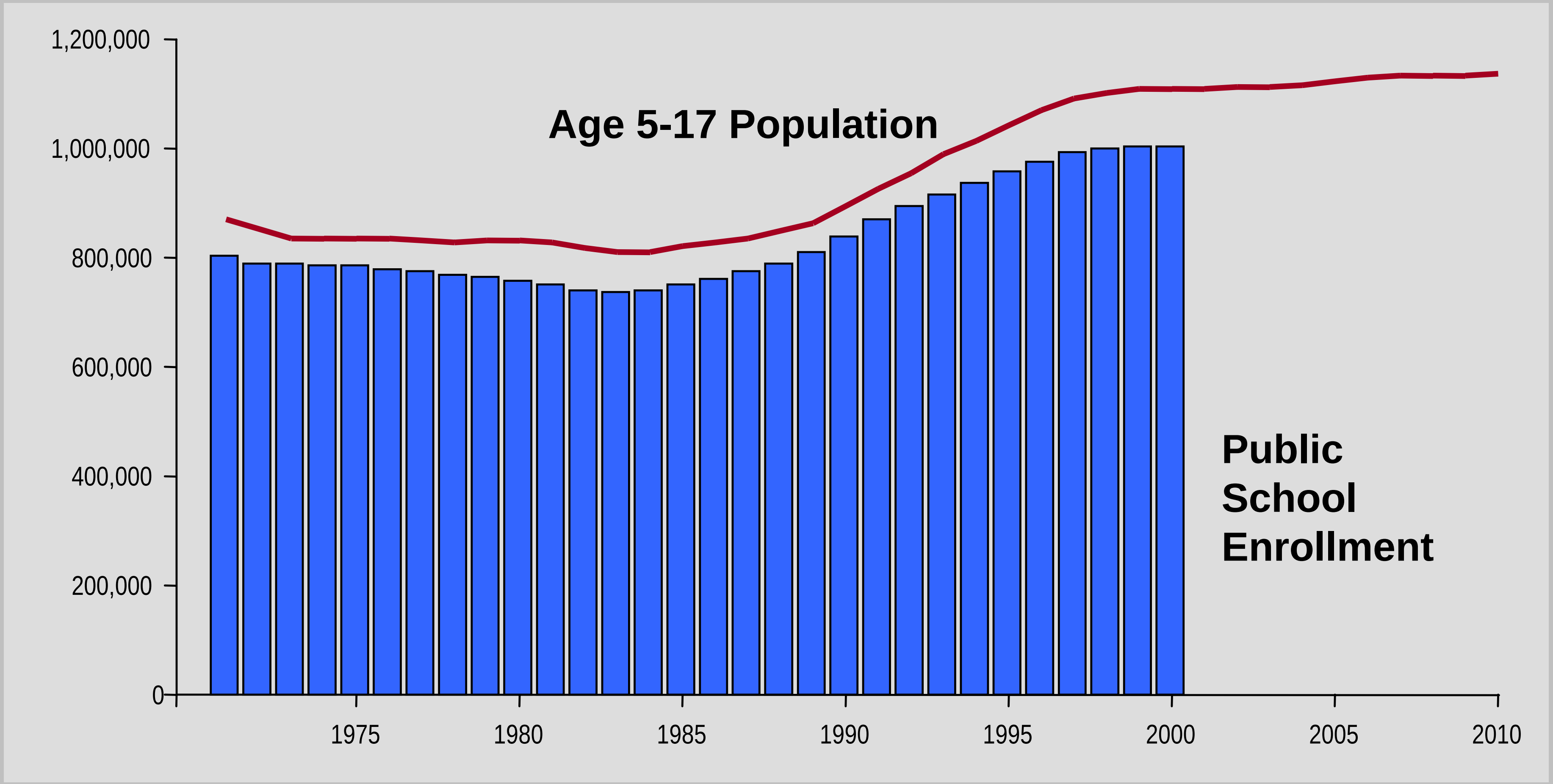
Policy choices can offset demographic pressures.



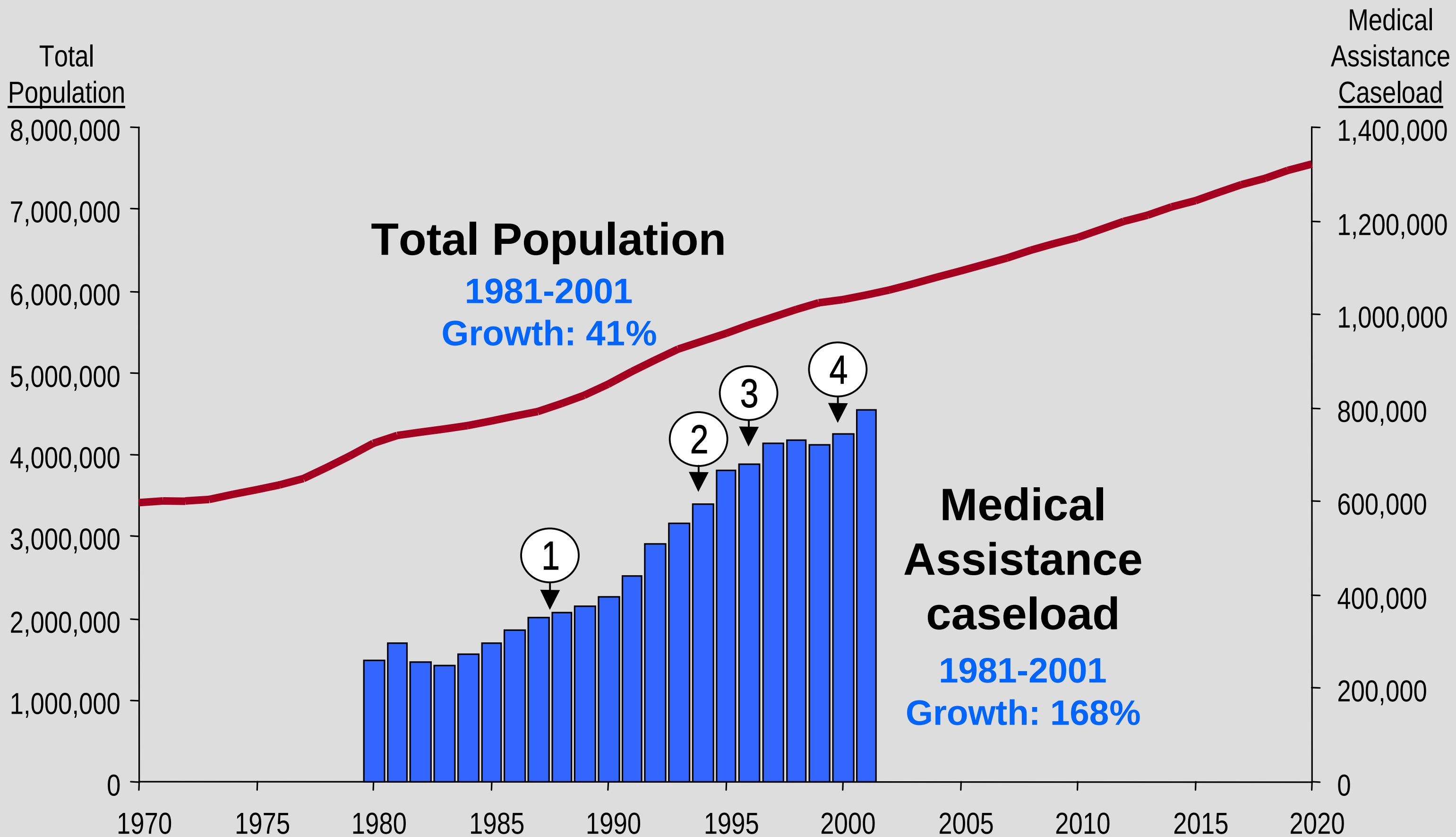
From 1970 through 1988 the prison population tracked the population fairly closely. The Sentencing Reform Act reduced the prison population. Emphasis on drug crimes increased the prison population.



Demography is a major factor in K-12 enrollment. In the medium term demographic pressures in K-12 will be very low.

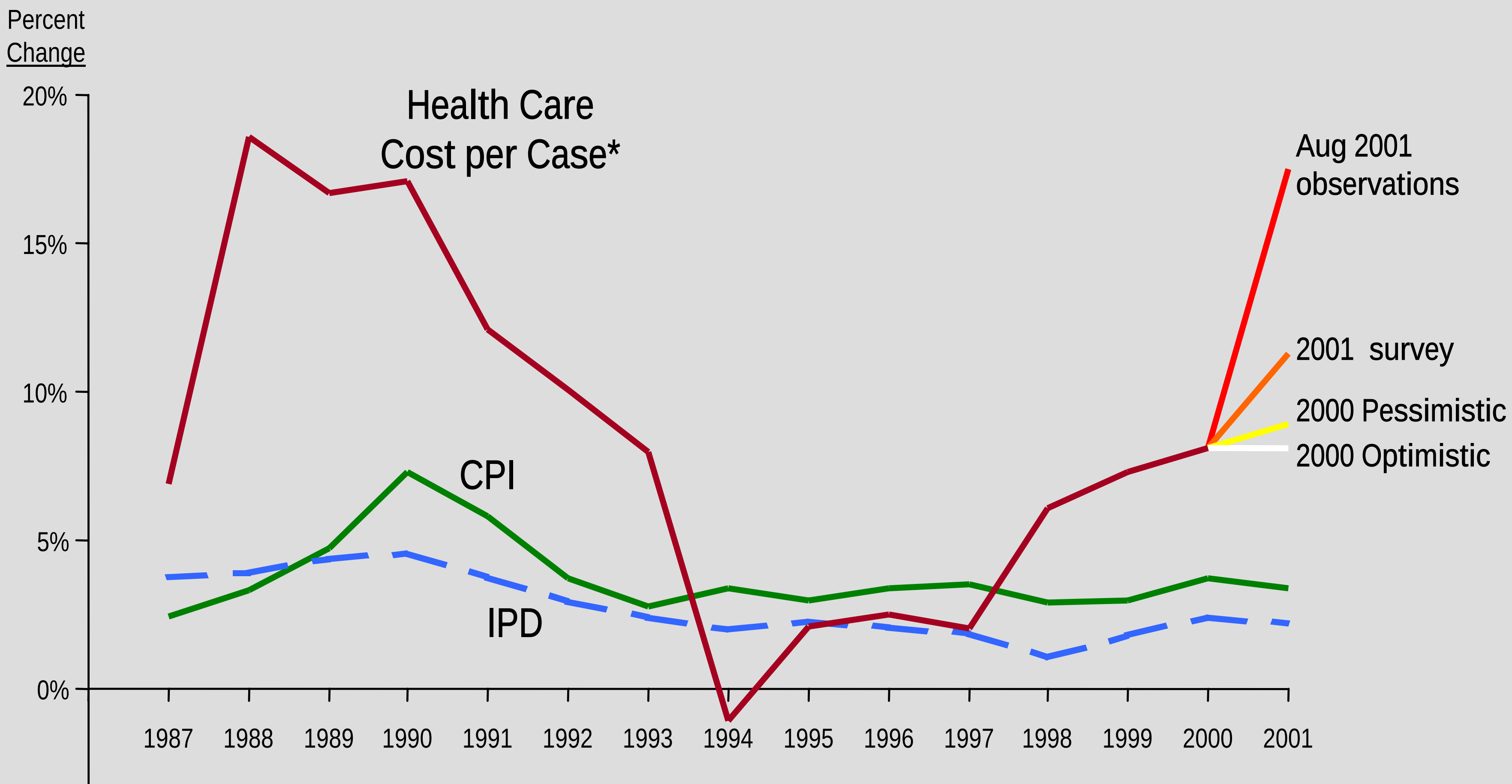


Policy factors have been a driver of Medical Assistance caseloads.



1. July 1988: First Steps expansion for children and pregnant women.
2. July 1994: Expansion to 200% federal poverty level (FPL) for children.
3. August 1996-August 1997: unintentional drop in AFDC/TANF related component as a result of Welfare Reform.
4. August 1999: TANF redetermination and reinstatement.

Health care costs are surging again.

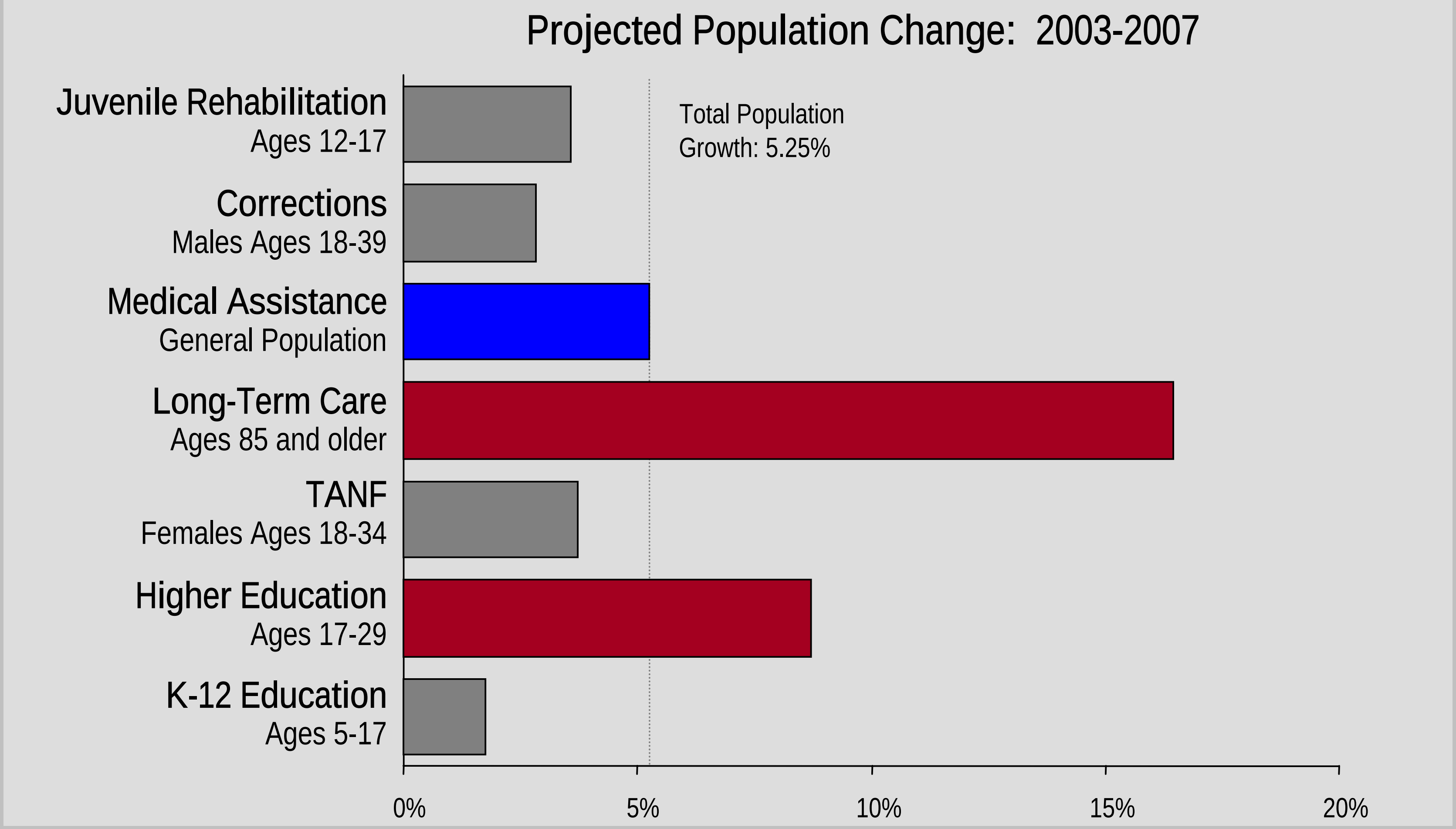


*Source: Historical data William M. Mercer, Inc., projected data supplied by OFM

Underlying Pressures Increasing Costs per Case in Health Care

- Traditional inflation: prices are up for same services and procedures
- New procedures, tests, and technology
- New drugs are driving up costs
- Advertising driving the demand for new drugs
- Aging population

Altogether, medium-term population pressures are high in Long-Term Care and Higher Education, but low for other major state government programs.



Context for Medium-Term Outlook

Spending, Revenue, and Reserves Beginning with the 2002 Supplemental Budget

Historical Context

- **$700 million in tax increases in 1993-95**
- **Passage of I-601. Limit took effect in the 1995-97 Biennium**
- **Expenditure growth cut in half since 1991-93 Biennium**
- **Legislatively adopted tax cuts and voter-approved tax and spending initiatives reduce revenue by $2.8 billion in current biennium**
- **$1.1 billion reduction in 2001-03 revenue forecast and $450 million increase in spending pressures since June**
- **Supplemental Budget as passed in March 2002 rebalances budget, resulting in $270 million projected reserve**

The reserve was never allowed to get very big.

Date(s) of Action		Cumulative Impact 1995-2003
1994-97	B&O tax reductions	$1.2 billion
1994-96	High tech and manufacturing tax reductions	$1.0 billion
1997	Referendum 47 property tax reductions	$600 million
1998	Referendum 49 General Fund license tab tax reduction	$300 million
1995-00	Forty other specific tax reductions	$600 million
1999	Initiative 695 – local revenue losses backfilled by state	$200 million
2000	Initiative 732 – mandatory teacher COLA	$344 million
2000	Initiative 728 – diversion to school districts	$ 470 million
	Cumulative Total	$4.7 billion

In 2001-03, these actions have reduced revenue available to the General Fund by $2.8 billion.

Budget Driver and Revenue Assumptions for the Medium-Term Fiscal Outlook

Revenue and Resource Assumptions
FY 2004 – FY 2007

- **Official February 2002 Economic and Revenue Forecast for 2001-03 Biennium and 2003-05 Biennium**
- **5.8% per year personal income growth after 03-05 (slightly less than past decade)**
- **5.0% per year underlying revenue growth after 03-05 (0.5% less than past decade**
- **Based on 0.85 elasticity, compared with 0.91 over past decade**
- **$150 million additional federal revenues (ProShare)**
- **$2.3 billion diversion to Student Achievement Fund through 05-07 under Initiative 728**

Spending Assumptions FY 2004 – FY 2007

(Builds on 2001-03 Supplemental Budget as passed in March 2002)

	Scenario 1	Scenario 2
Employee COLAs: Seattle CPI – 2.3%	X	X
Caseload growth – based on official caseload forecasts where available OR growth in associated population group	X	X
General inflation (goods and services): IPD – 2.2%	X	X
Higher education maintains its 01-03 participation rate.	X	X
No other policy adds are included.	X	X
Annual growth in health care costs	IPD (2.2%)	12%*

*Down from 15% in 01-03

Scenario 1: All programs grow based on caseload/specific population growth and general inflation. Revenue grows at 85% of personal income growth.

			PROJECTION			
	2002	2003	2004	2005	2006	2007
Total Revenues & Resources	$10,393	$11,389	$11,366	$11,643	$12,216	$12,813
Total Expenditures	$11,321	$11,162	$11,573	$11,941	$12,368	$12,819
DIFFERENCE	($928)	$227	($207)	($298)	($152)	($6)
TOTAL RESERVES/DEFICIT*	$75	$273	$31	($267)	($419)	($425)

*Includes statutorily required transfers to other funds.

Result: Revenue almost keeps pace with budget pressures. Deficit is manageable.

Scenario 2: Same as Scenario 1 except health care annual cost per case growth is 12%.

			PROJECTION			
	2002	2003	2004	2005	2006	2007
Total Revenues & Resources	$10,393	$11,389	$11,366	$11,643	$12,216	$12,813
Total Expenditures	$11,321	$11,162	$11,792	$12,412	$13,130	$13,917
DIFFERENCE	($928)	$227	($426)	($769)	($914)	($1,104)
TOTAL RESERVES/DEFICIT*	$75	$273	($187)	($956)	($1,870)	($2,974)

*Includes statutorily required transfers to other funds.

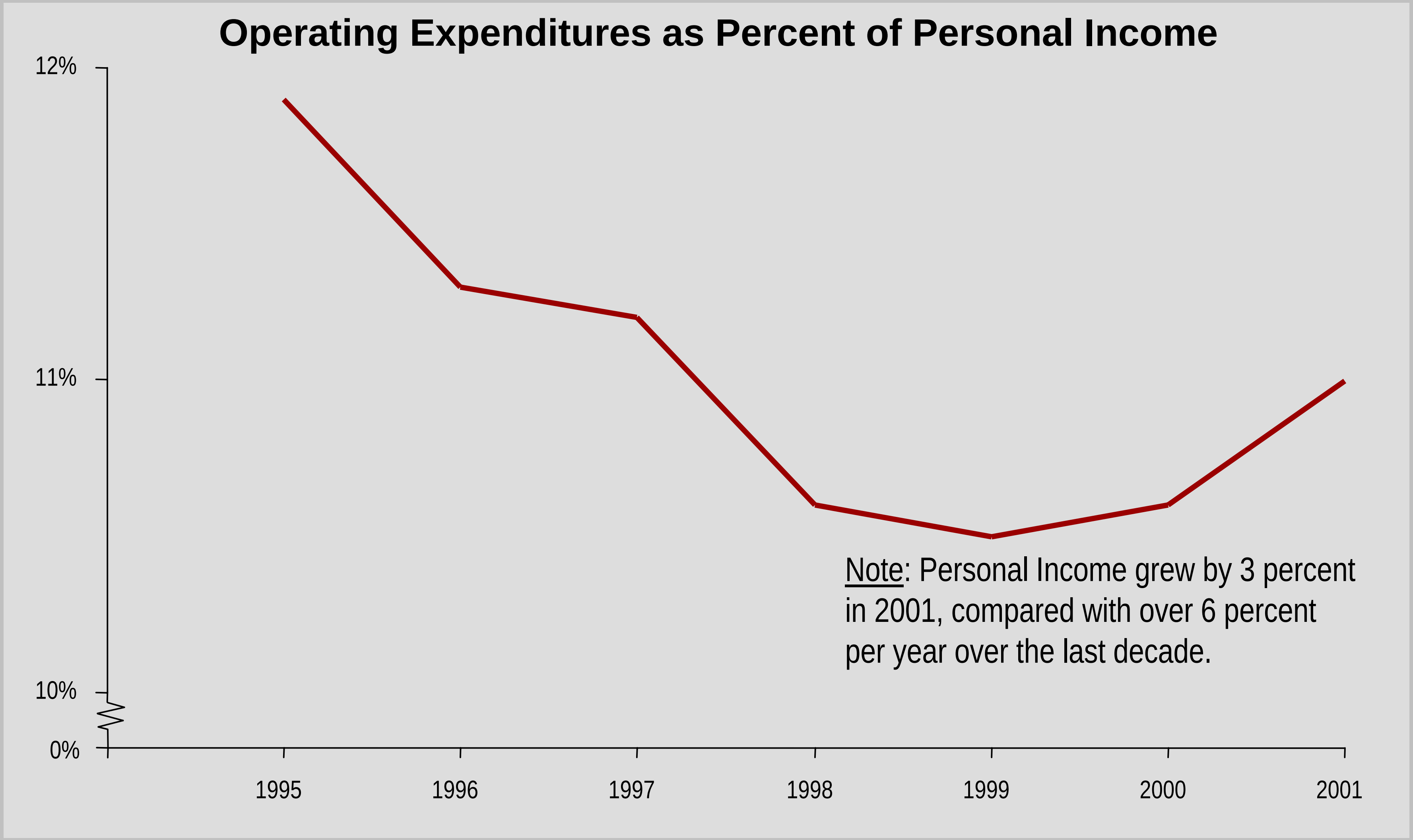
Result: Revenue does not keep pace with budget pressures. Deficit is difficult to manage.

Summary

- Over the past 30 years, actual expenditures have grown at about the same rate as the economy (as indicated by personal income).
- Since revenues (without tax changes) tend to grow more slowly than personal income, taxes and fees were raised periodically to keep pace.
- Reserves have not been allowed to grow very large during good economic times. They were quickly depleted due to increased spending or tax cuts.
- In the future, General Fund revenue would roughly keep pace with spending pressures – provided all caseloads and costs per case increase by population growth and general inflation.
- However, health care “inflation,” together with the future effects of tax cuts and spending initiatives, contributes to large projected structural deficits.

Implications for the Longer Term

Recently, operating expenditures have become a smaller share of the state economy.



Can government spending continue to grow more slowly than personal income?

Some implications of government spending growing more slowly than personal income

- It will be hard for spending on education, health care, and safety (comprising 80% of current budget), to keep pace with citizen demands.

- It will be hard for salaries and benefits to keep pace with those in the private sector. Private sector salaries grow faster than inflation, capturing the productivity gains in the economy.

On the other hand,

- Productivity gains and less spending on the rest of government (20% of budget) could help make room for a portion of the growth pressures in compensation, education, health care, and public safety..